5.02 Foreign Currency Exchange Transactions

An entity may enter into a transaction in which they agree to exchange one currency for another at a specific exchange rate at a specific future point in time. These foreign currency exchange transactions are often referred to as **forward exchange contracts**. There are many reasons an entity may enter into a forward exchange contract.

Some companies enter into forward exchange contracts as **hedges**. This would be the case if the entity has an "exposure" that is denominated in a foreign currency and it desires protection from fluctuations in exchange rates.

Using the same example, the company may have budgeted exactly $325,000 to purchase the printing press based on the exchange rate at December 15. Although it would be to its benefit if the exchange rate decreases, resulting in a gain, it may create financial difficulties for the entity if the exchange rate increases, requiring a larger payment.

To avoid this risk, the company may enter a forward exchange contract with another entity, referred to as a counterparty. The company will agree to buy 250,000 Euros at the exchange rate of 1.30 on January 15 of the following year.

- If the exchange rate increases above 1.30, the company will benefit from the transaction by being able to purchase the Euros for $1.30 per Euro, which is below market, and realize a gain.
- If the exchange rate decreases below 1.30, the company will be adversely affected as it will have to purchase the Euros for $1.30 per Euro, which is above the market price, and incur a loss.
- Regardless of whether the exchange rate increases, decreases, or remains unchanged, the company will buy 250,000 Euros for $325,000 and give them to Company X in exchange for the press. In essence, the company has eliminated the market risk associated with changes in the exchange rate.

The fact that an entity enters into a transaction for the purposes of mitigating some risk, using a hedge, does not necessarily mean that they will report the transaction using hedge accounting. ASC 815 establishes strict requirements that must be met in order for a transaction to be accounted for as a hedge.

Other companies may enter into forward exchange contracts for **speculation** purposes. If a company has some reason to believe, for example, that an exchange rate is going to change in the future, it may enter into a forward exchange contract:

- To *buy* that currency at a future date at a predetermined exchange rate if they believe that rate will be higher on that date.
- To *sell* that currency at a future date at a predetermined exchange rate if they believe that rate will be lower on that date.

Another reason companies may enter forward exchange contracts is to "**protect**" the reported value of an investment on their F/S. A company, for example, may have an investment in a foreign entity that is reported as a single amount on its balance sheet. In addition to the effects of the entity's performance, the carrying amount of the investment may be affected by changes in exchange rates. To isolate the effects of performance and eliminate the effects of a change in exchange rates, the company may enter a forward exchange contract as the seller.

- If the reported value of the investee decreases due to a decrease in the exchange rate, the forward exchange contract would increase in value due to the company's ability to sell the foreign currency at the higher contract exchange rate.
- If the reported value of the investee increases due to an increase in the exchange rate, the forward exchange contract would decrease in value, resulting in a liability, since the company will be required to sell the foreign currency at the lower contract exchange rate.

Speculation

Unless an entity qualifies for and chooses to account for its forward exchange contracts as hedges, they will all be accounted for as if entered into for speculation purposes. Forward exchange contracts are forms of **derivatives** and all derivatives that are not designated as hedges are required to be reported at their fair values, with gains or losses resulting from fluctuations of those values reported in profit or loss (I/S).

The fair value of a forward exchange contract is determined by the exchange rate that is used to value it. The types of exchange rates that might be used are:

- The **spot rate**, which is the actual exchange rate on a particular date; or
- The **forward rate**, which is what the exchange rate is expected to be at some point in the future.
  - There might be, for example, 30-day, 60-day, or 90-day forward rates.
  - A 60-day forward rate would indicate the exchange rate that is expected to be in effect 60-days from that date.

A forward exchange contract is generally entered into at the appropriate forward rate as of the date of the contract.

For example, on June 1 of the current period, a company enters into a forward exchange contract in which they agree to buy 100,000 Euros 90 days in the future. They prepare quarterly financial statements and, as a result, their next financial statements will be prepared as of June 30. The contract will be settled with a net payment on August 29, at the end of 90 days.

Applicable exchange rates are:

	June 1	June 30	August 29
Spot rate	1.30	1.33	1.29
60-day forward rate	1.35	1.39	1.28
90-day forward rate	1.37	1.42	1.30

On June 1, when the contract is entered into, it will be based on the 90-day forward rate, since that is the rate that is expected to apply when the contract will be settled at the end of

90 days. In essence, the company is agreeing to buy 100,000 Euros for $137,000 ($1.37) on August 29, and the counter party is agreeing to sell 100,000 Euros for $137,000.

Since each party is basically required to exchange currencies that are expected to be equal in value and as a result, the forward exchange contract would have no value at that time. *No entry would be recorded*, although both parties would have disclosures to make.

On June 30, the forward exchange contract will be adjusted to at its fair value for financial statement purposes. Although the actual fair value may differ due to the time value of money, volatility, and other factors, the fair value would approximate the difference between the expected values of the currencies that will be exchanged as of the balance sheet date.

As of June 30, the contract will now be settled at the end of 60 days. On June 30, the 60-day forward rate is 1.39 indicating:

- The buying party will be paying $137,000 for Euros that are expected to be worth $139,000. The fair value of the forward exchange contract would be approximately $2,000.
- The selling party will be receiving $137,000 for Euros that are expected to be worth $139,000. The forward exchange contract represents an obligation to be reported as a liability for approximately $2,000.
- *The buying party will recognize a gain and the selling party will recognize a loss.*

The buying party's entry may be:

Forward exchange contract	2,000	
Gain on forward exchange contract		2,000

The seller's entry may be:

Loss on forward exchange contract	2,000	
Forward exchange contract		2,000

The contract will be settled on August 29, when the spot rate is 1.29. The buyer would theoretically pay $137,000 to the seller for Euros that are actually only worth $129,000. In reality, however, the buyer will pay the seller the difference of $8,000. Since the exchange rate has gone from 1.39 at June 30 to 1.29 at August 31, the buyer will incur a loss, and the seller will have a gain, of 100,000 × the difference of $.10 or $10,000.

The buying party's entry may be:

Loss on forward exchange contract	10,000	
Forward exchange contract		2,000
Cash		8,000

The seller's entry may be:

Cash	8,000	
Forward exchange contract	2,000	
Gain on forward exchange contract		10,000